**Office of Chief Counsel**
**Internal Revenue Service**
**memorandum**
CC:LM:NR:DAL:2:POSTF-148808-01
EHarris

date: February 26, 2002

to: [redacted] Appeals Team Manager (LM)
Appeals Officer (LM)

from: Mark E. O'Leary
Associate Area Counsel (LMSB)

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[redacted] **Corporation**
**Foreign Currency Exchange Losses**

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The advice is subject to the Large Case Coordination Procedures of CCDM 35(19)4(4) pursuant to which a copy of this memorandum has been forwarded to the Associate Chief Counsel for review. Within ten days of receipt, the Associate Chief Counsel will provide a concurrence, a concurrence subject to revisions, or a request for additional information or time for analysis. Our office will inform you of the nature of that response.

## Introduction

As the common parent of an affiliated group of corporations, the Taxpayer files a consolidated federal income tax return using the accrual basis of accounting. The Taxpayer [redacted] and related products for sale in the United States and Mexico, where the Taxpayer owns a number of [redacted] Mexican operating subsidiaries through a Mexican holding company. During fiscal [redacted],[1] the Taxpayer engaged in a series of transactions designed to convert a portion of its capital investment in the holding company into debt. In connection with these transactions, the Taxpayer claimed certain foreign currency exchange losses under section 988.[2] Upon audit of the Taxpayer's [redacted] through [redacted] returns,[3] the examination division disallowed the claimed losses on various grounds, and the Taxpayer appealed to your office. You have requested our advice regarding the merit of the proposed adjustments and the proper tax treatment of the subject transactions.

## Facts

In [redacted], the Taxpayer [redacted]

[redacted]

[redacted]

[redacted]

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[1] The Taxpayer uses a fiscal year ending September 30.

[2] Except as otherwise indicated, section references are to the Internal Revenue Code of 1986, as amended and in effect during the years at issue.

[3] Although [redacted] is outside the scope of the current audit, we have considered the related events and tax items occurring in that year for the sake of completeness.

[4] [redacted]

[redacted]

[redacted]

[redacted]

Assumptions

For purposes of our analysis, we have assumed the following additional facts existed at all relevant times:

1. The NP was not a hyperinflationary currency as defined in 1.988-1(f).
2. Other than the Interest Adjustment, no primary or correlative allocations under section 482 were made by exam.
3. Neither [redacted] nor the Subsidiaries had any current or accumulated earnings and profits.
4. The Taxpayer's adjusted tax basis in the stock of [redacted] exceeded US$[redacted].
5. The Taxpayer made no election under section 1504(d) with respect to [redacted] or the Subsidiaries.
6. [redacted] and the Subsidiaries were solvent.
7. [redacted] and the Subsidiaries had no income effectively connected with a U.S. trade or business.
8. Under Mexican Law, the Resolution obligated [redacted] to distribute the USD-equivalent of NP $[redacted] rather than the authorized payment of US$[redacted].
9. [redacted] and the Subsidiaries used the Mexican New Peso (NP) as their functional currency as defined by section 985.

Summary of Issue and Conclusion

Whether the proposed adjustments should be sustained and on what basis?

The adjustments proposed in the agent's primary position should be sustained, although not on the grounds cited. We believe the transactions in question should be treated as a distribution of the USD Note with a pledge of the NP Notes as collateral.

Authorities

Under sections 985 *et seq.*, foreign currency gain or loss attributable to so-called section 988 transactions is computed separately and treated as ordinary income or loss. See I.R.C. § 988(a)(1)(A). A section 988 transaction includes the acquisition or acceptance of an obligation under a debt instrument if the amount the taxpayer is entitled to receive (or is required to

pay) is denominated in (or determined by reference to) a non-functional currency. See I.R.C. § 988(c). For this purpose, a debt instrument is any bond, debenture, note or certificate or other evidence of indebtedness. See Treas. Reg. § 1.988-1(a)(2)(i). If the substance of a section 988 transaction differs from its form, the timing, source, and character of gains or losses with respect to the transaction may be recharacterized by the Commissioner in accordance with its substance. See Treas. Reg. § 1.988-2(f).

Foreign currency gain or loss is that realized by reason of changes in exchange rates on or after the booking date and before the payment date. See I.R.C. § 988(b)(1) and (2). The holder of a nonfunctional currency debt instrument realizes exchange gain or loss with respect to a given payment of principal equal to the difference between the functional equivalent of the principal on the date of receipt and the functional equivalent on the date of acquisition of the instrument. See Treas. Reg. § 1.988-2(b)(5). The sum of any foreign currency exchange gain or loss with respect to principal is realized only to the extent of the total gain or loss realized on the transaction. See Treas. Reg. §§ 1.988-2(b)(8) and (9)(examples 3-5). Realized foreign currency gain or loss is recognized in accordance with the general principles of the Code. See Treas. Reg. §§ 1.988-2(a)(1)(i) and 1.988-2(b)(4) and (6).

To the extent provided by regulations, the Commissioner is authorized to integrate section 988 transactions that are part of section 988 hedging transactions. See I.R.C. § 988(d). Under the applicable regulations, integrated treatment is permitted for a qualified hedging transaction, which is defined as an integrated economic transaction consisting of a "qualifying debt instrument" and a section 1.988-5(a) hedge. See Treas. Reg. § 988-5(a)(1). A hedge is defined as a spot, futures, forward, option, notional principal contract, currency swap contract, or similar financial instrument (or series or combination of such instruments), which, when integrated with a qualifying debt instrument, permits a yield to maturity to be calculated on the hedged debt instrument in the hedge currency. See Treas. Reg. § 1.988-5(a)(4)(i). According to the regulations, a qualified hedging transaction does not include a hedge between related parties as defined under section 267(b) or 707(c)(1). See Treas. Reg. § 1.988-5(a)(5)(iii).

To obtain integrated treatment, a taxpayer must identify its transaction as a qualified hedging transaction by complying with certain record-keeping requirements. See Treas. Reg. § 1.988-5(a)(8)(i)(A)-(E). The Commissioner is authorized to identify a qualifying debt instrument and a hedge as a qualified hedging

transaction if (1) the taxpayer enters into a qualifying debt instrument and a hedge but fails to comply with one or more of the identification requirements; and (2) on the basis of all the facts and circumstances, the Commissioner concludes that the qualifying debt instrument and the hedge are, in substance, a qualified hedging transaction. See Treas. Reg. § 1.988-5(a)(8)(iii).

Integration of a qualified hedging transaction consisting of a debt instrument and a related hedge results in treatment of the ostensibly separate legs of the transaction as a single synthetic debt instrument denominated in the hedge currency. See I.R.C. § 988(d)(2). As a result, no exchange gain or loss is realized under section 988 on either the debt instrument or the hedge independently of the other. See Treas. Reg. § 1.988-5(a)(9). Therefore, if the hedge currency is the USD, the synthetic debt instrument resulting from integration is treated as a USD-denominated debt instrument, and foreign currency gain or loss will not be realized on the transaction by a taxpayer using the USD as its functional currency. See Treas. Reg. § 1.988-5(a)(1).

Section 301 governs the tax consequences to a shareholder of a corporate distribution of property, including cash, securities, and other property except stock in the distributor or rights to acquire that stock. See I.R.C. §§ 301(a) and (c). The amount of a distribution of property, including nonfunctional currency, equals its fair market value on the date received. See I.R.C. § 301(b)(1). See generally American Home Products Corp., 601 F.2d 540 (Ct. Cl. 1979)(fair market value of nonfunctional currency determined based on applicable exchange rate on date of receipt). To the extent a distribution constitutes a dividend out of current or accumulated earnings and profits, it must be included in gross income. See I.R.C. § 301(c)(1). Any amount remaining reduces the shareholder's adjusted basis in the distributor's stock but not below zero. See I.R.C. § 301(c)(2). Any excess of the non-dividend portion is capital gain. See I.R.C. § 301(c)(3). The distributee's basis in the distributed property is its fair market value on the date of distribution. See I.R.C. § 301(d).

For both accrual and cash basis distributees, a dividend is included in gross income when the cash or property is actually received or unqualifiedly made subject to the shareholder's demand so as to be considered received under principles of constructive receipt. See Treas. Reg. § 1.301-1(b). See also Treas. Reg. §§ 1.451-2(a) and 1.451-2(b). Whether income is constructively received is a question of fact. See Avery v. Commissioner, 292 U.S. 210 (1934). In the case of a dividend, a three part test is applied to determined constructive receipt:

(1) does the shareholder have an unrestricted, legal right to demand payment; (2) do the parties have a contrary agreement to defer payment and; (3) does the corporation have the ability to fulfill the dividend. See American Air Filter Co. v. Commissioner, 81 T.C. 709, 725 (1983); Bush Bros. & Co. v. Commissioner, 73 T.C. 424, 438-439 (1979), aff'd, 668 F.2d 252 (6th Cir. 1982). See, e.g., Moser v. Commissioner, T.C. Memo. 1989-142. Moreover, a legal right to payment is not determinative if the parties nevertheless intend to defer payment, for example, due to the corporation's illiquidity or need for working capital.

In Avery v. Commissioner, a corporation routinely mailed dividend checks on the last day of the month in which the dividend was payable or, in the case of shareholders who were officers or employees, distributed the checks on the first business day of the following month. See id. at 212. The Supreme Court found this practice reflected the intention of the declaring corporation that the stockholders would not receive the dividends until the following month; the funds were therefore not unqualifiedly subject to the demand of the stockholder as a result of declaration of the dividend and issuance of the checks.

No deduction is allowed for any loss from the sale or exchange of property between certain related persons, including members of a controlled group. See I.R.C. § 267(a)(1) and Treas. Reg. § 267(f)-1(e). Under section 267, the term controlled group has the meaning given that term by section 1563(a) except substituting 50% for the 80% stock ownership requirement. See I.R.C. § 267(f)(1). An exception to this rule exists for FCE losses realized with respect to nonfunctional currency debt between members of a controlled group so long as the loan does not have as a significant purpose the avoidance of federal income tax. See I.R.C. § 267(f)(3)(C).

In general, federal income tax consequences are governed by the substance of a transaction as determined by the intentions of the parties, the underlying economics, and all other relevant facts and circumstances. See Gregory v. Helvering, 293 U.S. 465, 470 (1935). The label the parties affix to a transaction does not determine its character. See Helvering v. Lazarus & Co., 308 U.S. 252, 255 (1939). In applying the doctrine of substance over form, ostensibly separate but interrelated steps may be integrated. See Commissioner v. Clark, 489 U.S. 726, 738 (1989). To determine whether steps should be integrated, three separate tests have been applied: the end-result test; the time test; and the interdependence test. See McDonald's Restaurants of Illinois, Inc. v. Commissioner, 688 F.2d 520, 524-25 (7th Cir. 1982); Penrod v. Commissioner, 88 T.C. 1415, 1429-430 (1987).

Under the end-result test, integration is appropriate when all of the steps are intended as part of a unitary plan from the outset. See Kanawha Gas & Utils. Co. v. Commissioner, 214 F.2d 685, 691 (5th Cir. 1954).

Whether a disposition of property has occurred for tax purposes is a practical determination based on the facts and circumstances of each case. See Haggard v. Commissioner, 24 T.C. 1124, 1129 (1955), aff'd, 241 F.2d 288 (9th Cir. 1956). A transaction is a sale if the benefits and burdens of ownership have passed. See Highland Farms, Inc. v. Commissioner, 106 T.C. 237, 253 (1996). Generally, if both the risk of loss and the possibility of profit are transferred, the transaction is a sale and not a loan. See Town & Country Food Co., 51 T.C. at 1057.

Discussion

The loss on the First Transaction should be disallowed for a number of reasons,[5] foremost among them being that there was no constructive distribution of US$[redacted]. The Taxpayer's characterization of the First Transaction as an exchange of US$[redacted] for the USD Note assumes that the Resolution resulted in a constructive distribution of US$[redacted] by virtue of a shareholder's right to enforce the distribution under Mexican law. However, constructive receipt requires not only a right to payment but an unqualified right, that is, a right that has not been modified or restricted by a contrary agreement between the parties. See Treas. Reg. §§ 1.451-2(a) and 1.451-2(b).

The facts in this case disclose an agreement that the distribution would be paid with debt, notwithstanding the Taxpayer's legal right to demand payment in cash under Mexican law. This agreement is evidenced by a series of interrelated events surrounding the Resolution. Prior to the Resolution, [redacted] began to convert the NP Accounts into the NP Notes to facilitate the issuance of debt to the Taxpayer. [redacted] while solvent, had no liquid assets. [redacted] days after the Resolution, [redacted] transferred the USD Note stated to be in fulfillment of the

[5] The First and Second Transactions are clearly not section 988 transactions. See I.R.C. § 988(b)(1) and (2). Even if the Taxpayer received a constructive distribution of US$[redacted] and exchanged it for the USD Note, the excess US$[redacted] in consideration paid by the Taxpayer over the fair market value of the USD Note would be treated as a capital contribution to [redacted]. Cf. Treas. Reg. § 1.301-1(l).

Resolution. [redacted] days after that, the NP Notes were assigned. Moreover, the parties did not intend that the Taxpayer would demand payment in cash, forcing [redacted] to dispose of the NP Accounts. Consequently, the Taxpayer did not have an unqualified right to payment as required for constructive receipt. See American Air Filter Co. v. Commissioner, 81 T.C. at 725.

The tax consequences of the First and Second Transactions should be determined based on their economic substance considering the application of the step-transaction doctrine. See Commissioner v. Clark, 489 U.S. at 738; Gregory v. Helvering, 293 U.S. at 470. Beginning with the conversion of the NP Accounts, the Taxpayer intended that the First and Second Transactions would be executed as part of a unitary plan resulting in [redacted]'s distribution of US$[redacted]. As steps in that unitary plan, the First and Second Transactions should be integrated to determine their economic substance. See Kanawha Gas & Utils. Co. v. Commissioner, 214 F.2d at 691. The end result of these transactions was a distribution by [redacted], the question is what, in substance, was distributed--the USD Note secured by a pledge of the NP Note or the NP Notes outright. That determination depends on whether the benefits and burdens of ownership of the NP Notes were transferred focusing primarily on the risk of loss and the opportunity for profit.

The Letter Agreement is ambiguous on this point. In favor of an outright distribution is the fact that the Letter Agreement refers to the transaction as a substitution for the USD Note, the revisions to the Letter Agreement increasing that appearance. Booking the debt on [redacted] rather than [redacted], is also more consistent with an outright distribution of the NP Notes. In addition, the Taxpayer imputed interest on the NP Notes from the Subsidiaries, as opposed to [redacted], and the examiner accepted this treatment in making the Interest Adjustment.

However much the Taxpayer's reporting, bookkeeping, and labeling of the transaction is consistent with an outright transfer, the risk of loss from default is most determinative. In this case, [redacted] bore the risk of loss from the Subsidiaries' default on the NP Notes so long as the USD Note remained outstanding. The Letter Agreement specifically provides that the USD Note was to remain outstanding until after all payments were received. In an outright transfer, one would expect to see a cancellation of the USD Note as consideration for the NP Notes. Due to the Gross-Up Obligation, [redacted] also retained the risk of loss from devaluation of the NP.

The Taxpayer did not acquire a realistic opportunity for profit on the NP Notes. Although the principal amount of the NP

Notes was US$[redacted] more than that of the USD Notes, the parties did not know that at the time. Consequently, there was no expectation or intention, much less requirement, that the Subsidiaries would pay the Taxpayer more than US$[redacted]. Because the NP Notes were not interest bearing, the Taxpayer could not profit from changes in interest rates. Nor was exchange rate gain a reasonable prospect at the time.

Considering all the facts and circumstances, we believe the NP Notes were assigned as collateral for the USD Note, primarily because the Taxpayer did not assume the risk of loss or acquire the opportunity for profit. See Town & Country Food Co., 51 T.C. at 1057. Therefore, the substance of these transactions was a distribution of the USD Note with an assignment of the NP Notes as collateral. Since no part of the distribution of the USD Note constituted a dividend, the entire amount of US$[redacted] reduced the Taxpayer's basis in the stock of [redacted]. See I.R.C. § 301(c)(2). The Taxpayer received a basis in the USD Note of US$[redacted]. See I.R.C. § 301(d). The Taxpayer would not be entitled to any FCE losses under section 988 because the USD Note is denominated in functional currency. The Taxpayer's receipt of US$[redacted] pursuant to the Gross-Up Obligation would be treated as repayment of a debt, not taxable income.

[redacted], (b)(5)(AC), (b)(5)(AWP)

[redacted]

Even if the Taxpayer held the NP Notes outright, the Taxpayer did not bear the risk of FCE losses to the extent of the Gross-Up Obligation, which served as a hedge of those losses with respect to US$[redacted] of the principal amount of the NP Notes. Under the applicable regulations, such a hedge may be integrated with a related debt instrument into a synthetic debt instrument denominated in the hedge currency. See Treas. Reg. § 1.988-5(a)(1). Ordinarily, a related-party hedge is not a qualifying hedge under section 988, but the Commissioner is authorized to integrate a qualifying debt instrument with a related but non-qualifying hedge upon a determination from all the facts and circumstances that the substance of the arrangement warrants integration. See Treas. Reg. § 1.988-5(a)(8)(iii). The Gross-Up

Obligation functions as a direct, dollar-for-dollar hedge of any FCE losses and therefore should be integrated with the NP Notes into a synthetic debt instrument in the principal amount of US$[redacted] denominated in USD. See I.R.C. § 988(d)(2). For tax purposes, the NP Notes should be bifurcated into a US$[redacted] synthetic debt denominated in functional currency (USD Portion) and a US$[redacted] nonfunctional currency debt (NP Portion). The USD Portion representing approximately [redacted]% of the NP Notes and the USD Portion representing the remaining [redacted]%. Each principal payment on the NP Notes should be bifurcated between the USD Portion and the NP Portion on that basis. FCE losses may be calculated on the part of the principal allocated to the NP Portion.

In calculating the amount of the Gross-Up Payment, the Taxpayer allocated all of the principal payments to the first US$[redacted]. Considering both the NP and USD Portions, the aggregate FCE losses on the NP Notes were US$[redacted]. By allocating [redacted]% of the principal payments to the NP Portion, the Taxpayer would be entitled to US$[redacted] in FCE losses with respect to the NP Portion. The remaining US$[redacted] in losses attributable to the USD Portion should have been reimbursed by [redacted] pursuant to the Gross-Up Obligation. Therefore, [redacted]'s actual payment of US$[redacted] pursuant to the Gross-Up Obligation was short by US$[redacted]. By accepting less than the amount required from [redacted], the Taxpayer has US$[redacted] in unrecovered basis in the USD Portion. The gratuitous forgiveness of the balance of this obligation should be treated as a nondeductible contribution to capital. See Treas. Reg. § 1.61-12(a).

Conclusion

We believe the substance of these transactions is a distribution of the USD Note secured by a pledge of the NP Notes. Accordingly, the Taxpayer should not be allowed any of the tax items claimed in connection with these transactions [redacted]

, (b)(5)(AC), (b)(5)(AWP)

, (b)(5)(AC), (b)(5)(AWP)

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